

NOTE ON STATE AUDIT SERVICE'S CLAIMS TO NAFTOGAZ

- Last week, Ukrainian media reported allegations of the State Audit Service of Ukraine (SASU) against Naftogaz.
- In a leaked report, the state auditor alleges Naftogaz, the largest dividend and tax payer to Ukraine's state budget, has failed to pay as much as UAH 75 billion of dividends to the state.
- The SASU's claims are rooted in inefficient regulations of the Cabinet of Ministers, which often contradict the law or create "gray areas" open for arbitrary interpretation.

IFRS 9 vs. Resolution 899

- The largest claim relates to the fact that Naftogaz makes provisions for doubtful debts. Such provisions reduce the company's profit and therefore the dividends available to the shareholder.
- While such provisions are made in accordance with the International Financial Reporting Standard (IFRS) 9 and are stipulated by the Law of Ukraine on Accounting and Financial Reporting, the SASU believes such provisions should not have been made.
- The state auditors refer to Resolution 899 introduced by the government of Prime Minister Azarov in 2012 as an instrument to keep management of state-owned enterprises (SOEs) under political control. This resolution prohibits certain activities of SOEs (incl. making capital investments and provisions for impairment) unless the government has approved the financial plan of such a company.
- Since 2012, it has been customary for the government to delay approval of financial plans either to exert pressure on SOE management or to avoid responsibility. In recent years, the government approved the financial plan of Naftogaz for 2017 in July 2017 under pressure from the EBRD, never approved one for 2018 and approved the financial plan for 2019 in December 2019 following an order from the National Security and Defense Council.
- According to the Constitution of Ukraine, laws of Ukraine are superior to the government's resolutions. Therefore, Naftogaz ignored Resolution 899 where it directly contradicted the Law on Accounting and Financial Reporting, as well as the IFRS. Moreover, our investors in bonds require us to report according to IFRS.

Impairment provision for trade accounts receivable

- As at the end of 2019, Naftogaz had UAH 147 billion (USD 5.7 billion) of trade accounts receivable, including UAH 63 billion overdue for over 365 days and UAH 17 billion overdue accounting for over 6 months. Also, it is publicly known that certain amounts of more current debts from clients, which buy gas under the public-service obligation (PSO) regime introduced by the state, are not sufficiently financed by their own regulated tariffs. Such amounts therefore are unlikely to be collected on time.
- Guided by the principle of prudence and requirements of IFRS 9, Naftogaz creates provisions for impairment to properly reflect the quality of its trade accounts receivable. As at 31 December 2019 accumulated provisions amounted to UAH 88 billion.
- Such provisions are ignored by the tax code of Ukraine, and Naftogaz has paid all related taxes (incl. VAT, royalty and profit tax) to the state budget despite the fact that these receivables have not been collected. Such payments put a strain on the company's working capital.
- Provisions for bad debts, however, impact the company's ability to pay dividends to the state as a 100% shareholder.

- Given the fact that in recent years the state has set dividend rate at 75-95% of Naftogaz' profit, the SASU draws a conclusion that Naftogaz would have been required to pay a significantly larger amount of dividends had the provisions not been made.
- However, the state auditor fully ignores the fact Naftogaz would not have the capacity to finance such dividends, since the provisions relate to the trade accounts receivable which are not likely to be collected.

Inefficient state regulation is the primary reason of doubtful debts

- In most cases, inability of Naftogaz to collect such accounts receivable is driven specifically by the regulatory regime introduced by the government.
- Nearly 85% of the provisions relate to the debts from clients that received gas under the government's PSO Resolutions. Such clients include, for instance, municipal heating companies and Odesa Port Plant.
- Remaining 15% of the provisions relate to debts from commercial clients, mostly located in the temporarily occupied territories of Donetsk, Luhansk regions and Crimea and originated prior to March 2014. Currently Naftogaz sells gas to commercial clients on the prepayment basis or based on solid banking guarantees.
- Therefore, by its regulations, the state required Naftogaz to supply gas to non-paying clients and enabled them to evade Naftogaz' efforts to minimize damage.

Alarming political attack on corporate governance reform

- Through the conclusions of SASU, the state claims that the decision on how and where to put trade receivables and other financial figures in the reports is not an obligation of the management, but a discretionary decision of the shareholder – the state in case of SEOs – which effectively gives the shareholder the possibility to “cook the books” in any fashion thus undermining the entire idea of proper governance and proper reporting for all businesses in Ukraine.
- The position of SASU is alarming and dangerous because it disregards Ukraine's international obligations, limits access to financial markets and contradicts the Law on Accounting and Financial Reporting, which implemented the IFRS in Ukraine.
- The recent attack on Naftogaz driven by regulatory inefficiencies also causes concern over political meddling and corruption. The case of SASU's claims to Naftogaz demonstrates that the government is not held accountable for the regulatory loopholes it creates for syphoning money from SOEs. On the contrary, management of such companies is confronted with risks of fines and, potentially, criminal prosecution based on the SASU's often ungrounded allegations.
- Since 2015, Ukraine, backed by the EBRD, the IMF and the OECD, has attempted a reform of corporate governance in its SOEs. It is important that companies where this reform has been implemented are freed from the politically-driven audit of SASU. Independent supervisory boards, functioning systems of internal controls and regular audit by internationally recognized auditors provide transparent and professional protection of the state's interest in SOEs.